BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of )
)
BOWERMAN'S PHARMACY, INC.' )

For Appellant: James S. Cappis
Attorney at Law

For Respondent: James C. Stewart
Counsel

## O P I N I O N

These appeals are made pursuant to section 25666 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of Bowerman's Pharmacy, Inc., against proposed assessments of additional franchise tax in the amounts of $6,628.75, $2,388, $3,768, and $4,500 for the income years 1971, 1974, 1975, and 1976, respectively.

-*peals of Bowerman's Pharmacy, Inc.

The issue presented by these appeals is whether advances appellant made to its parent corporation constituted bona fide debts, and, if so, whether they were partially worthless during the years on appeal.

Appellant was incorporated in California and operated a number of small drug stores in San Francisco. Its stock was acquired by Sierra Coast Pharmacies, Inc. (Sierra) in 1969. Prior to the acquisition by Sierra, 9 percent of appellant's outstanding stock was owned by one M. Hurst, and the remaining stock was owned by five employees of appellant. The acquisition was accomplished by Sierra first purchasing Mr. Hurst's interest, giving him an unsecured note for the entire purchase price, and then purchasing the employee-shareholders' interests for $429,000, giving them $325,000 cash and notes totaling $104,000. The notes to the employee-shareholders were secured by the Bowerman's stock owned by Sierra. Sierra raised most of the $325,000 down payment through a loan from an unrelated corporation. This loan was secured by appellant's assets.

At the time of the acquisition, appellant had substantial liquid assets which Sierra planned to use to pay for the acquisition. Pursuant to this plan, appellant began making advances to Sierra immediately after the acquisition. In 1969, it advanced $50,000 to Sierra. In 1970, Sierra sustained a $100,000 loss and was delinquent in the payment of some of its obligations. By the end of 1971, Sierra was in default on all its debts. Notwithstanding Sierra's financial difficulties, 'appellant advanced an additional $50,000 to Sierra in 1970,. and, in 1971, after appellant sold three of its stores and sold options to purchase its remaining three stores, it advanced to Sier-ra an additional $383,220.

Appellant characterizes the advances to Sierra as loans and contends that they were partially worthless in 1971. In that year, appellant wrote off $100,000 of the advances as worthless and claimed that amount as a bad debt deduction on its 1971 corporate tax return. In each of the years 1974, 1975, and 1976, appellant wrote off $50,000 of the advances as worthless and claimed that amount as a bad debt deduction. Upon audit, respondent disallowed the claimed bad debt deduction for each of the years on appeal and issued a proposed'assessment of additional tax for each year. After considering appellant's protests, respondent affirmed the proposed assessments, and a timely appeal followed for each of the years. By agreement of the parties, the appeals were consolidated.

Respondent contends that the advances were not bona fide debts and, therefore, that the bad debt deductions were properly disallowed. In the event this board finds the advances to be bona fide debts, respondent argues that appellant has failed to prove they were partially worthless during the years on appeal.

Revenue and Taxation Code section 24348 allows as a deduction bad debts which became worthless during the income year and provides that respondent may allow a deduction for a partially worthless debt to the extent the debt is charged off during the year. However, only a bona fide debt gives rise to a bad debt deduction. (Former Cal. Admin. Code, tit. 18, reg. 24348(d), subd. (3) (Repealer filed Sept. 3, 1982, Register 82, No. 37).) A bona fide debt is defined as "a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money." (Former Cal. Admin. Code, tit. 18, reg. 24348(d), subd. (3).) Whether an advance from a corporation to a shareholder creates a debtor-creditor relationship depends primarily on whether the advance was made with the intent that it be repaid. (Chism's Estate v. Commisssioner, 322 F.2d 956 (9th Cir. 1963); Appeals of George K. and Ann H. Nagano, et al., Cal. St. Bd. of Equal., Dec. 10, 1981.) The true intent of the parties is ascertained by considering the facts surrounding the advances. (Chism's Estate v. Commissioner, supra; Elliott J. Roschuni, 29 T.C. 1193 (1958), affd., 271 F.2d 267 (5th Cir. 1959), cert. den., 362 U.S. 988 [4 L.Ed.2d 1021] (1960).) Factors which are generally considered in determining the parties' true intent include: (1) whether a note or collateral was given: (2) how the advance was treated by the parties; (3) whether any interest was stated or paid; (4) whether there was an agreed upon repayment date; (5) whether any repayment was made; and (6) whether, at the time the advance was made, there was a reasonable expectation of repayment. (Elliott J. Roschuni, supra; William E. Riley, ¶ 81,705 P-H Memo. T.C. (1981).)

In cases such as this, where the party receiving the advance is in control of the corporation making the advance, the situation must be closely scrutinized. (Jacob M. Kaplan, 43 T.C. 580 (1965); Appeals of George K. and Ann H. Nagano, et al., supra.) In such cases, the taxpayer can prevail only on a clear showing that a bona fide debt was intended. (Cf. Ludwig Baumann & Co., ¶ 61,271 P-H Memo. T.C., affd., 312 F.2d 557 (2d Cir. 1963).) We find that appellant has failed to make such a showing.

Appellant relies, upon several factors in an attempt to support its position that the parties intended the advances to be bona fide debts. The first is that both appellant and Sierra treated the advances as loans on their corporate books and records. While this is some evidence of an intent to create a debt, it is not determinative. Rather, it is merely one factor to be considered in light of all the facts. (Jacob M. Kaplan, supra.)

Appellant contends that the parties agreed that interest would be paid on the advances and that the advances would be repaid at a specific time. As evidence of this agreement, appellant submitted minutes of its board of directors meetings held in 1969 and 1970. The 1969 minutes authorize appellant's officers to make loans to Sierra and specify an interest rate and repayment date, but do not contain any express provision for the use of a promissory note. While these minutes provide some support for appellant's position in that they indicate that appellant intended the 1969 advance to be repaid with interest, their significance is substantially diminished by the fact that the total of advances authorized conflicts with the amount appellant actually advanced and that no explanation is offered for this discrepancy. The 1970 minutes provide no support for appellant's position. Although these minutes authorize certain loans, they do not specify either an interest rate or a repayment date. In addition, the actions authorized by the 1970 minutes do not correspond to the actions taken by appellant's officers in that the amount of loans authorized differs from the total of the 1970 advances and in that the minutes call for Sierra to provide promissory notes which it did not do.

Appellant emphasizes that, in 1970, both corporations accrued interest on the advances and argues that this factor is entitled to great weight since the corporations had no tax-related reason for accruing the interest. Appellant explains that it is an accrual basis taxpayer and that it paid franchise tax on a portion of the accrued interest, whereas Sierra had a loss in 1970 without deduction of the accrued interest and thus gained no tax benefit from the accrual. Although we agree that, under these circumstances, the accrual of interest does indicate an intent to create a debt, even the actual payment of interest does not conclusively establish advances to be loans. (See, Midland Distributors, Inc. v. United States, 30 Am.Fed.Tax R.2d 5306 (D.C. Fla. 1972), affd., 481 F.2d 730 (5th Cir. 1973).) Therefore, the accrual of interest, along with the other factors relied upon by appellant, must be considered in light of all the facts.

We find the factors relied upon by appellant unconvincing in light of the factors which show that the advances were not bona fide debts. Of particular significance is the fact that appellant made the advances without receiving any notes or collateral although the advances were considerable in amount, and, as discussed below, were made to a corporation in serious financial trouble. In addition, despite the fact that Sierra did not make any repayment of the advances, appellant never made any attempt to either obtain repayment or to compel Sierra to secure the advances. Finally, we agree with respondent that, at the time the advances were made, it was not reasonable for appellant to expect that the advances would be repaid. Respondent determined that, during all the years in which advances were made, Sierra was insolvent in the sense that its liabilities exceeded its assets when those assets were fairly valued. Such a financial situation supports a conclusion that the advances were made without a reasonable expectation of repayment. (Worthham Machinery Company v. United States, 521 F.2d 160 (10th Cir. 1975).)

Sierra's financial statements for 1969, 1970, and 1971 were submitted by appellant in an attempt to establish that Sierra was solvent in 1969. However, these statements actually support the opposite conclusion. Sierra's 1969 financial statement shows assets of $117,396 and current liabilities of $84,259. The assets listed on that statement are identical to those listed on Sierra's 1971 financial statement which appellant admitted were of little or no value in 1971. Yet appellant offered no explanation as to how these same assets could be valued at over $117,000 in 1969, merely two years earlier. Without such an explanation, and evidence supporting it, we must conclude that the assets were as worthless in 1969 as they were in 1971.

Appellant also submitted a copy of a permit issued to Sierra in September 1969, by the California Corporation Commissioner allowing Sierra to sell an additional $100,000 worth of capital stock. It contends that this demonstrates that Sierra was in sound financial condition in 1969. We do not agree since appellant has not presented any evidence showing that the Corporation Commissioner either considered or made any determination concerning the solvency of the corporation.

Appellant next argues that even if we find that Sierra was insolvent in 1969, the permit to issue additional stock proves that it was reasonable to assume that

Sierra's financial condition would improve and that it would then be able to repay the advances. We cannot accept this argument. Although the issuance of the permit may prove that Sierra intended to seek capital contributions totaling $100,000, appellant has presented no evidence to indicate that there was any possibility of Sierra actually selling the additional stock. On the contrary, given Sierra's precarious financial situation, it was likely that obtaining additional capital contributions would be difficult. Furthermore, appellant acknowledged that, during the years at issue, small drugstores were facing stiff competition from large discount drugstores. Since appellant has not proven that it was reasonable to believe that Sierra's financial condition would improve, we must agree with respondent that there existed no reasonable expectation of repayment at. the time the advances were made.

Appellant points out that the shareholders from whom Sierra purchased the shares of Bowerman's stock accepted promissory notes from Sierra knowing that appellant's assets would be used to make the payments on these notes. Appeliant argues that this fact proves that the advances were bona fide debts, but we do not agree. The actions of the selling shareholders may indicate their belief that together appellant and Sierra would be able to make the required payments to them. However, the selling shareholders had no continuing financial interest in appellant and, thus, would not be concerned with whether Sierra was able or intended to repay the advances from appellant.

The evidence appellant presented does 'not constitute a clear showing that the advances were intended to be bona fide debts. Given Sierra's financial position during the time the advances were made, it is highly unlikely that one intending to be repaid would make such substantial advances without any written agreement, note, or security. Therefore, we must conclude that the advances from appellant were made without the intent to create a bona fide debt and that appellant is not entitled to the claimed bad debt deductions. Since the advances were not bona fide debts, it is unnecessary for this board to determine whether they were partially worthless in the years on appeal.

For the foregoing reasons, respondent's action must be sustained.

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## O'R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests of Bowerman's Pharmacy, Inc., against proposed assessments of additional franchise tax in the amounts of $6,628.75, $2,388, $3,768, and $4,500 for the income years 1971, 1974, 1975, and 1976, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 26th day of October , 1983, by the State Board of Equalization, with Board Members Mr. Bennett, Mr. Collis, Mr. Dronenburg, Mr. Nevins and Mr. Harvey present.

William M. Bennett , Chairman

Conway H. Collis , Member

Ernest J. Dronenbura, Jr., Member

Richard Nevins , Member

Walter Harvey* , Member

*For Kenneth Cory, Per Government Code section 7.9

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of )
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BOWERMAN'S PHARMACY, INC. )

ORDER DENYING PETITION FOR REHEARING

Upon consideration of the petition filed November 21, 1983, by Bowerman's Pharmacy, Inc. for rehearing of its appeal from the action of the Franchise Tax Board, we are of the opinion that none of the grounds set forth in the petition constitute cause for the granting thereof and, accordingly, it is hereby ordered that the petition be and the same is hereby denied and that our order of October 26, 1983, be and the same is hereby affirmed.

Done at Sacramento, California, this 12th day of September, 1984, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Dronenburg, Mr. Collis and Mr. Bennett present.

Richard Nevins, Chairman

Ernest J. Dronenburg, Jr. Member

Conway H. Collis, Member

William M. Bennett Member

Member